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27468—37

In the Supreme Court of the United States

OCTOBER TERM, 1937

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLARENCE M. FREEDMAN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Third Circuit entered in the above cause on August 23, 1937, reversing the decision of the United States Board of Tax Appeals.

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 11–21) is reported in 34 B. T. A. 956. The opinion of the Circuit Court of Appeals for the Third Circuit (R. 62) is reported in 92 F. (2d) 150.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 23, 1937 (R. 65). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether compensation received by one who renders services to a State is immune from Federal income taxation where the compensation is not paid out of the funds of the State.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra*, pp. 11–14.

STATEMENT

The facts in this case, as found by the Board of Tax Appeals (R. 11–16) are as follows:

The taxpayer is a lawyer, practicing his profession in Philadelphia, Pennsylvania (R. 11). On October 2, 1931, the Attorney General of the Commonwealth of Pennsylvania directed to the taxpayer a letter reading as follows (R. 12):

> It gives me pleasure to appoint you an attorney in this Department assigned to the liquidation work of the Department of Banking. Your salary will be at the rate of $3,000.00 per annum.
>
> The Special Deputy Attorneys General who are assigned to this work in Philadelphia are being advised of your appointment

and that you will be available to assist them in any way in which they may find it necessary to call upon you.

The taxpayer accepted the appointment conferred by the above letter. He was thereafter continuously employed on matters relating to the liquidation of closed banks, as hereinafter more fully related, until March 9, 1935, when his employment was terminated on the occasion of a change in the political party in control of the state government, whereupon he was directed to turn his files over to his successor. (R. 12.)

The Department of Justice and the Department of Banking are administrative divisions of the Commonwealth of Pennsylvania. The head of the Department of Justice is the Attorney General and the head of the Department of Banking is the Secretary of Banking, those offices being provided for by statute. The Attorney General has statutory power "to appoint and fix the compensation of special deputy attorneys general, and special attorneys, to represent the Commonwealth, or any department, board, or commission thereof, in special work or in particular cases." Purdon's Pennsylvania Statutes Annotated, Permanent Edition, Title 71, Section 296 (b). (R. 12.) The Secretary of Banking is by statute given broad powers over banks within the Commonwealth. When it appears to him that a bank is in an unsafe or unsound condition he may, after notice and hearing and with the consent of the Attorney General, take

possession of the business and property of the bank; under certain conditions he may take possession without hearing and without the Attorney General's consent. When he takes possession of a bank, he is vested with "all the rights, powers, and duties of a receiver appointed by any court of equity in this Commonweath"; while in possession of the bank he is "the representative of the creditors" thereof. The banking law provides that, in the case of banks the property of which is in the possession of the Secretary of Banking, all expenses of such possession and of continuing the business or of liquidation "shall first be payable out of the funds of" such bank "including the compensation of special deputies, assistants, and others employed by the secretary to assist him in such proceedings; the allowance of all such expenses to be subject to the approval of the court." Purdon's Pennsylvania Statutes Annotated, Permanent Edition, Title 7, Sections 29, 49. (R. 12–13.)

The taxpayer was assigned to work under special deputy attorneys general in Philadelphia County in connection with legal matters pertaining to closed banks in that county. Such closed banks were being liquidated by the Secretary of Banking pursuant to statute. The taxpayer's duties consisted of attempting to collect debts due such closed banks, rendering legal opinions to the deputy receivers in charge thereof, handling the legal matters for the banking department that came up from

surrounding counties, prosecuting suits in court, consulting with creditors, depositors, and stockholders of closed banks concerning their claims, procuring substitute trustees for trust estates being administered by such banks, preparing, filing, and presenting accounts in the Orphan's Court, preparing data in connection with the proposed state banking code, and in general anything that was assigned by the Special Deputy Attorney General at the time. Attorneys such as the taxpayer were considered by the Department of Justice as "available for any purpose at any time." (R. 13–14.)

The taxpayer handled legal matters for the state banking department in connection with the liquidation of several closed banks in the Philadelphia area, and was one of approximately twenty lawyers assigned to like work in Philadelphia County (R. 14).

The particular work and the matters to which the taxpayer gave attention were determined by the Attorney General's office. He was free to use his discretion only in simple matters. In regard to all proposed litigation and appeals, he was required first to consult with his superior officers. He was required to follow prescribed forms issued by the Attorney General's office as to preparation of documents and pleadings. His legal opinions were reviewed and often revised by his superiors before being issued. Likewise, his briefs were reviewed and frequently entirely redrafted. All matters of policy in particular cases were decided by

the Attorney General and his deputies. The taxpayer's advice to depositors of closed banks was limited to matters on which his superiors had ruled. Attorneys in the taxpayer's position were instructed to take no steps and render no opinions on any legal problem involved in closed banks without approval of the Attorney General. (R. 14.)

The taxpayer's duties and the manner in which they should be performed were prescribed in part by a large number of mimeographed circulars issued by the Attorney General at Harrisburg at frequent intervals and sent to all attorneys handling closed bank matters. Also, his instructions were received periodically from a Deputy Attorney General at regular meetings held for the purpose of discussing their problems and deciding on procedure. (R. 14–15.)

The taxpayer received no compensation for his services other than his $3,000 salary, but was reimbursed for his expenses. He was furnished with necessary office facilities. He was required to use official letterheads furnished by the Department of Justice, and signed his letters as "attorney" for the Department of Justice. The files in matters handled by him were considered the property of the State and were turned over by him to his successor when his employment was terminated. While the Department of Justice could have required all his time, and had first call on his services, he was permitted to engage in private practice. In 1932 he spent more than 50 per cent of his time

on state business. He had to give up certain regular employment to accept the employment in the Department of Justice. His professional income for 1932, aside from the $3,000 salary, was $2,735.60. He was not a member of a law firm. (R. 15.)

The taxpayer's salary was paid to him semi-monthly by checks drawn by representatives of the state banking department in charge of closed banks in Philadelphia, the checks being countersigned by the Secretary of Banking at Harrisburg. In the early part of 1932 his salary was charged against funds of three closed banks whose assets had been taken over by the Secretary of Banking, but later in the year it was charged against funds of four closed banks, although his services were not confined to matters relating to the affairs of those particular banks. The banks against which the taxpayer's salary was charged were determined by the Attorney General and the Secretary of Banking. The salaries of attorneys handling matters relating to the several closed banks were ordinarily paid out of the funds of such banks in approximate proportion to the amount of work done for each bank. (R. 15.)

The taxpayer did not include in his income tax return for 1932 the $3,000 received as compensation for services rendered to the department of banking (R. 16). The Board of Tax Appeals held that this compensation was not immune from Federal taxation and was includable in the taxpayer's taxable income for 1932, and made an order

of deficiency (R. 17, 21). The Circuit Court of Appeals reversed the decision of the Board of Tax Appeals.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the compensation received by the taxpayer as a Special Deputy Attorney General of Pennsylvania was not subject to Federal income taxation.

2. In failing to hold that the taxpayer was neither an officer, an employee, nor an agent of the State, engaged in an essential governmental function of the State.

3. In failing to hold that even if the taxpayer were an officer, an employee, or an agent of the State, Federal taxation of the compensation received by him out of funds of insolvent state banks imposes no prohibited burden upon the State.

4. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The decision of the court below in the instant case is in direct conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *McLoughlin* v. *Commissioner,* 89 F. (2d) 699, No. 287, present term, certiorari granted, October 11, 1937. There it was held that the compensation of an attorney employed by the State of New York and engaged in the liquidation of insolvent

insurance companies was not immune from Federal income taxation for the reason that the compensation in that case was paid out of the funds of the companies liquidated. The decision below did not discuss the *McLoughlin* case nor did it discuss the fact largely relied on by the court in deciding that case, and which is present in this case, that the compensation of the taxpayer was paid wholly out of the property of the insolvent companies liquidated. The facts of the instant case and of the *McLoughlin* case are so similar that it cannot be doubted that the decision below directly conflicts with the conclusion of the Circuit Court of Appeals for the Second Circuit (89 F. (2d) 703):

> * * * we are persuaded that a liquidating agent paid wholly out of the property of an insolvent is not entitled to exemption.

The decision below is in accord with the decisions of the Circuit Court of Appeals for the Fifth Circuit in *Therrell* v. *Commissioner,* 88 F. (2d) 869, No. 128, present term, and *Tunnicliffe* v. *Commissioner,* 88 F. (2d) 873, No. 129, present term, certiorari granted in both on October 11, 1937. In the *Therrell* case the taxpayer was appointed liquidator of a number of banks in Florida. His compensation came from the funds of the banks being liquidated. The *Tunnicliffe* case involved similar facts. In both cases the decision of the Board of Tax Appeals, which had denied exemption from income taxation of this compensation, was reversed, one judge dissenting. The court in

the *McLoughlin* case, *supra,* expressed itself as obliged to differ with the decision of the majority in those two cases.

2. The precise question presented in *McLoughlin* v. *Commissioner, supra, Therrell* v. *Commissioner, supra, Tunnicliffe* v. *Commissioner, supra,* and the instant case, has never before been passed upon by this Court, and is of current administrative importance.

CONCLUSION

It is in the public interest that the conflict here presented be resolved by an authoritative decision.

Wherefore it is respectfully submitted that this petition should be granted.

STANLEY REED,
Solicitor General.

NOVEMBER, 1937.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

Purdon's Pennsylvania Statutes, Annotated, Permanent Edition, Title 7:

SEC. 9. *Maintenance of department and assessment of expenses.*

(a) *Expenses*—All moneys derived by the department from fees, assessments, charges, penalties, and otherwise, shall be paid by the Secretary, through the Department of Revenue, into the State Treasury for safe-keeping and shall, by the State Treasurer, be placed in a separate fund, to be available for the use of the department upon requisition of the secretary. All such moneys so paid into the State Treasury are hereby specifically appropriated to the de-

partment for the purpose of paying the salaries of the secretary, the deputies, the examiners, and the other employes of the department, the expenses of the department,

* * *

The Auditor General shall, upon requisition of the secretary from time to time, draw warrants upon the State Treasurer for the amounts specified in such requisitions, not exceeding, however, the amount in such fund at the time of the making of any such requisition.

(b) *Assessments of Expenses upon Corporations and Individuals*—All the expenses incurred in and about the conduct of the business of the department, including the cost of the regular examinations of corporations and persons under the supervision of the department, the compensation of the secretary, deputies, examiners, and other employes of the department, together with all other general or overhead expenses of the department, shall be charged to and paid by the corporations and persons subject to the supervision of the department, in equitable proportions, at such times and in such manner, as the secretary shall by general rule or regulation annually prescribe:

* * * * *

On failure or refusal of any such corporation or person, after thirty days' written notice, to pay any sum lawfully assessed or charged against it or him by the secretary under the provisions of this clause, the secretary shall call upon the Department of Justice to bring an action at law to recover the same. (1923, June 15, P. L. 809, § 9; 1927, April 13, P. L. 182, § 1; 1929, April 25, P. L. 716, § 1.)

SEC. 49. *Expenses to be paid out of fund.* All assessments, charges, and penalties due to the department by such corporation or person, all expenses of the taking and maintaining possession of the business and property or the continuing of the business by the secretary, and all expenses of liquidation under the provisions of this act, shall first be payable out of the funds of such corporation or person, including the compensation of special deputies, assistants, and others employed by the secretary to assist him in such proceedings; the allowance of all such expenses to be subject to the approval of the court. (1923, June 15, P. L. 809, § 49.)

Treasury Regulations 77:

ART. 56. *State contracts.*—The profit of an independent contractor from a contract with a State or political subdivision thereof must be included in gross income. Where warrants are issued by a city, town, or other political subdivision of a State, and are accepted by the contractor in payment for public work done, the fair market value of such warrants should be returned as income. If for any reason the contractor upon conversion of the warrants into cash does not receive and can not recover the full value of the warrants so returned, he may deduct from gross income for the year in which the warrants are converted into cash any loss sustained, and if he realizes more than the value of the warrants so returned he should include such amount in his gross income of the year in which realized.

ART. 643. *Compensation of State officers and employees.*—Compensation paid to its officers and employees by a State or political subdivision thereof for services rendered in

connection with the exercise of an essential governmental function of the State or political subdivision, including fees received by notaries public commissioned by States, is not taxable. Compensation received for services rendered to a State or political subdivision thereof is included in gross income unless (a) the person receives such compensation as an officer or employee of a State or political subdivision, and (b) the services are rendered in connection with the exercise of an essential governmental function. The commissions of receivers appointed by State courts are taxable.

An officer is a person who occupies a position in the service of the State or political subdivision, the tenure of which is continuous and not temporary and the duties of which are established by law or regulations and not by agreement. An employee is one whose duties consist in the rendition of prescribed services and not the accomplishment of specific objects, and whose services are continuous, not occasional or temporary. * * *.

U. S. GOVERNMENT PRINTING OFFICE: 1937